Uniform Commercial Code Committee of the
Business Law Section of the State Bar of California

November 5, 2006

BY EMAIL TRANSMISSION

Permanent Editorial Board for the
Uniform Commercial Code
c/o The American Law Institute
4025 Chestnut Street
Philadelphia, Pennsylvania 19104

Re: In re Commercial Money Center, Inc.

Ladies and Gentlemen:

We are writing to you on behalf of the Uniform Commercial Code Committee of the Business Law Section of the State Bar of California (the "UCC Committee") to address certain specific concerns of the UCC Committee with respect to the decision In re Commercial Money Center, Inc.[1] (the "Case"). Considerable discussion has been generated over the Case, including on the Washburn University School of Law "UCCLaw-L -- UCC Law Discussion List" (the "UCC ListServ").[2] The UCC Committee wishes to supplement this discussion and, hopefully in the process, address some of the points raised in the UCC ListServ discussions. Please note that in this letter we have only included a basic summary of the issues and holdings in the Case, as we assume most are generally familiar with the Case.[3]

1. Summary of Issues and Holdings in the Case

A. Issue: Are the payment streams under the equipment leases "chattel paper" within the meaning of Section 9-102(a)(11) or "payment intangibles" within the meaning of Section 9-102(a)(61)?

Holding: The payment streams are payment intangibles.[4]

---

[1] In re: Commercial Money Center, Inc., U.S. Bankruptcy Appellate Panel of the 9th Circuit, BAP No. SC-05-1238-MoTB; Bk. No. 02-09721-H7; Adv. No. 03-90331.
[2] See: http://lists.washlaw.edu/mailman/listinfo/ucclaw-l/.
[3] A further discussion on the background of securitizations, the commercial reasons for "stripping" and a schematic diagram of the Case and other securitization structures can be found in the Appendices to this letter.
[4] Although the court evidently believed that this legal conclusion is one of the holdings in the Case, some have argued that this legal conclusion amounts to "obiter dictum." For purposes of this letter, we will treat this legal conclusion as a holding (without attempting to resolve that debate).

B. Issue: Were the transactions concerned sales of the payment streams or loans secured by the payment streams?[5]

Holding: The transactions were loans, not sales.

C. Issue: Was NetBank's security interest in the payment streams perfected by possession of the related equipment leases?

Holding: The Case was remanded for a factual determination as to whether NetBank, through an agent, had possession of the equipment leases.

2. Loan vs. Sale

Of the holdings in the Case, the finding that the underlying transaction was a loan, and not a sale, appears to be uncontroversial. The transaction between the assignor (Commercial Money Center) and the assignee (NetBank) involving a pool of sub-prime equipment leases was found to be a loan and not a sale. The court reached this conclusion because the assignee had none of the potential benefits or risks associated with ownership of the lease chattel paper and equipment. In making this determination, the court rightfully looked to the substance of the allocation of risks in the transaction, and not the form or purported characterization of the transaction by the parties. Based on the court's conclusion, the assignee's security interest could be perfected either by filing a financing statement or by taking possession of the equipment leases. No financing statement was ever filed. However, because there was a dispute about whether the assignee had taken possession of the leases through an agent, the court remanded the Case for a determination of that factual issue.

3. "Stripping" and the Creation of Payment Intangibles

The court found that Commercial Money Center created payment intangibles by separately assigning its interest in the payment streams under certain equipment leases and its interest in the leases themselves, which, in the court's view, effectively "carved out" or "stripped" the payment streams from the underlying chattel paper (even though the separate assignments were made in the very same agreement).[6] This holding is controversial due to the possibility that a security interest in chattel paper which is

[5] If the transactions were sales, NetBank's interest in the payment streams would be automatically perfected upon attachment under Section 9-309(3); however, if the transactions were loans, NetBank's interest in the payment streams could be perfected only by filing under Section 9-310(a) or (according to the court after discussing a 1991 bankruptcy case) by taking possession of the related leases.

[6] We note that most loans secured by equipment leases (*i.e.*, lease receivable discounting agreements) use granting language that includes both (1) an assignment of the lease payments and (2) a grant of a security interest in the underlying lease chattel paper and the leased equipment. Under the analysis in the Case, these transactions create payment intangibles by the mere use of words that "strip" the lease payments from the underlying leases. Although we are not aware of any lenders attempting to rely on automatic perfection under Section 9-309 in what are clearly loan transactions, we believe that most lenders and lessors would be surprised to learn that they are creating payment intangibles when they use the typical granting language of a loan against a lessor's lease receivables.

perfected by filing or by possession may, as to the related payment rights, be subordinate to the interest of a prior buyer of the payment rights, even if there is no actual, constructive or record notice of that interest. This holding is also problematic because it opens the door to "shifting" collateral from one type to another merely by using some words rather than others in an agreement, which creates various priority issues and results in other uncertainties under the UCC. These two issues -- the possible first priority of an unknown prior interest in the payment rights under equipment leases and other chattel paper and the potential problems created by "shifting" collateral types -- are discussed in sections 4 and 5 of this letter. Possible resolutions to the problems raised by these issues are discussed in section 6 of this letter.

4. The Relative Priority of Payment Intangible Buyers vis à vis Chattel Paper Purchasers

The primary problem raised by the Case but left unaddressed is the relative priority between a buyer of payment intangibles that were created (*i.e.*, stripped) from chattel paper and a subsequent "purchaser" of the chattel paper (including a buyer of the chattel paper and a lender taking an interest in the chattel paper to secure a loan). Assuming the applicability of the court's holding that payment rights stripped from the underlying chattel paper from which they arise constitute payment intangibles, the key question seems to be whether the "super-priority" rules of Section 9-330(b) and (c) allow a subsequent purchaser of chattel paper to obtain priority in the proceeds of such chattel paper (*i.e.*, the payments received under the chattel paper) -- the same payments presumably embodied in the previously sold payment intangibles. The resolution of this question primarily requires an examination of the interplay among Sections 9-318, 9-322(c) and 9-330(b) and (c), which interplay the court expressly did not undertake to examine in the Case.[7]

There seems to be a great deal of support from scholars and practitioners who have reacted to the Case for the position that a subsequent perfected purchaser of chattel paper meeting the requirements of Section 9-330(b) (*e.g.*, new value, possession or control, good faith, ordinary course of business and no knowledge of violation) should have priority with respect to the payments arising under such chattel paper vis-à-vis a prior purchaser of payment intangibles stripped from such chattel paper. However, there is certainly some difference of opinion as to whether Article 9 clearly produces this result.

With respect to the hypothetical question posed above, there seem to be two main issues raised by Article 9 and the Official Comments thereto. First, an ambiguity seems to arise from a plain reading of Section 9-318(a), which provides that a "debtor that has sold . . . a payment intangible . . . does not retain a legal or equitable interest in the

[7] The court did discuss Section 9-330(b), but stated that "[w]e explicitly decline to resolve the ambiguity in Revised UCC Section 9-330(b) . . . ." We assume for purposes of this discussion that the sale of the payment intangibles stripped from the chattel paper was indeed a true sale so that the buyer receives the benefit of automatic perfection under Section 9-309 and that the subsequent purchaser of the chattel paper complied with the requirements of Section 9-330(b) to obtain "super-priority" over other perfected security interests in the chattel paper.

collateral sold." As others have noted, this could mean that once a seller sold stripped payment intangibles from chattel paper, the seller would retain no more interest in such payment intangibles to sell to anyone else (*i.e.*, the subsequent purchaser of the chattel paper from such a seller would be buying chattel paper devoid of any rights to payments). Section 9-318(b) does not change this result inasmuch as it affects solely buyers of accounts and chattel paper who have not perfected their interests in such receivables and does not apply to buyers of payment intangibles or promissory notes. Moreover, Official Comment 4 to Section 9-318 can be read to underscore this point with respect to sales of payment intangibles, which are automatically perfected under Section 9-309.[8]

The second issue centers around whether the super-priority rules of Section 9-330 (including as they relate to priority over proceeds of such chattel paper) apply to the hypothetical facts at issue here since Section 9-330 could be read to apply only to disputes among creditors with interests in chattel paper <u>as original collateral</u>. In the question at hand, since the interest of the first buyer, at least as determined by the court in the Case, is in payment intangibles and not chattel paper, it could be argued that the rules of Section 9-330 do not apply to determine the priorities as between these two parties.[9] It should certainly be noted that several commentators disagree with this interpretation. For example, Steven Weise has made the point that Sections 9-330(b) and (c) and 9-322(c) can (and should) be read to govern the kind of dispute at issue in the hypothetical question generated by the Case -- where one of the two parties is claiming an interest in the "stripped" payment intangibles only. That argument is predicated on a not unreasonable reading of Section 9-322 (reinforced by Official Comment 8 thereto) that if the chattel paper purchaser's security interest "*qualifies* for priority over a conflicting security interest under . . . Section 9-330," the chattel paper purchaser's security interest "also has priority over a conflicting security interest in . . . the proceeds of the collateral." The word "qualifies" means that there does not have to exist an actual conflicting security interest in the chattel paper. However, others have expressed concern that Sections 9-330 and 9-322 are ambiguous enough on this point that a court could conclude otherwise.[10]

5. <u>Problems Created by "Shifting" Collateral Types under the UCC</u>

The court's most controversial holding in the Case is premised on the notion that, for purposes of classifying the types of collateral involved in the financing transactions between Commercial Money Center and NetBank, once the payment streams have been "stripped" from the underlying equipment leases (which, as noted above, is accomplished merely by separately assigning, even in the same agreement, the payment streams and the underlying leases), the payment streams under the equipment leases are analytically

---

[8] Official Comment 4 to Section 9-318 provides as follows: "If the security interest of a buyer of accounts or chattel paper is perfected, the usual result would take effect: transferees from and creditors of the seller could not acquire an interest in the sold accounts or chattel paper. The same result would occur if payment intangibles or promissory notes were sold, inasmuch as the buyer's security interest is automatically perfected under Section 9-309."

[9] As the court noted, "this special priority rule only applies by its terms to an interest 'in the chattel paper.' We have just held that the payment streams stripped from the leases are not chattel paper, so arguably this special priority rule is inapplicable." Case at 23.

[10] The summary of the issues in the paragraph were largely culled from a posting on the UCC ListServ by Robert Ihne.

severable from the equipment leases themselves. In the court's view, the leases constitute chattel paper because they are "records that 'evidence' a monetary obligation," but the payment streams do not constitute chattel paper because they "are not 'records' that 'evidence' monetary obligations, they are the monetary obligations." Having determined that the payment streams are a type of collateral distinct from chattel paper, the court ultimately determined the payment streams to be payment intangibles.

The problem with the analytical framework used by the court in the Case is that it moves Revised Article 9 somewhat off center. Now, instead of a unified set of perfection and priority rules that are well-designed and produce consistent results, we potentially have a system that creates different outcomes for essentially identical transactions, alters priority rules in unintended ways, introduces transactional risks that are not well-understood and creates uncertainty where formerly there was high degree of certainty.

Here is a sample of some of the difficult questions raised or unexpected results produced by the collateral classification holding and related analysis in the Case:

A. S sells all of S's rights in certain equipment leases to B, who neither files nor takes possession. B runs that risk that S can grant to a subsequent purchaser that files or takes possession a senior interest in the very same leases. However, if S "separately" (merely by using words of separate assignment, even if they appear in the same agreement) sells to B all of S's rights in the payments under the leases and all of S's other rights in the leases and if B neither files nor takes possession, then arguably under the holding of the Case, B has acquired a perfected security interest in the payment rights and an unperfected security interest in the other rights. Although B remains at risk with respect to the non-payment rights, B's interest in the payment rights (although not the subject of any filing) will trump the interest of a subsequent purchaser that acquires a security interest and perfects by filing and, because the payment rights are distinct from the leases themselves and (if separately assigned) do not constitute chattel paper, may even trump the interest of a subsequent purchaser that acquires a security interest and perfects by possession and otherwise meets the requirements for priority in chattel paper set forth in Section 9-330(b).

B. On Day 1, A sells all of its payment rights under certain equipment leases to B, who neither files nor takes possession. On Day 2, to secure an obligation, A grants a security interest in all of its rights under the leases to C, who immediately perfects by filing. The security agreement between A and C contains a negative pledge, which is set forth in all caps in C's filing. On Day 3, to secure an obligation, A grants a security interest in all of its rights under the leases to D, who takes possession. D meets all the requirements for priority under Section 9-330(b) with one exception: prior to entering into the transaction with A, D reviewed C's filing. Subsequently, A becomes insolvent and there is a priority contest among B, C and D. Assume for the moment that the court hearing the matter interprets Section 9-330(b) as implicitly granting A the power to transfer rights in the leases (including all payment and other rights thereunder) to a secured party. Assume further that the court agrees with the holding in the Case regarding the classification of collateral: if "stripped" (*i.e.*, separately assigned), the payment rights under the leases constitute payment intangibles. In the priority contest between B and C as to the payment rights under the leases, B wins under the first to file or perfect rule contained in Section 9-322(a)(1). In the priority contest between C and D as to the leases, D cannot rely on Section 9-330(b) to achieve priority over C (D was aware of the negative pledge), with the result that C wins under Section 9-322(a)(1). And in the priority contest between B and D as to the payment rights, it appears (as Steven Weise has argued) that D does have a security interest that qualifies for priority over a conflicting security interest under Section 9-330 and, therefore, D wins under Section 9-322(c)(2). In short, B trumps C, who trumps D, who trumps B. In light of this circular priority, how does the court rule?

C. S sells to B all of S's rights in certain promissory notes in a "servicing retained" transaction. Each of the notes is secured, pursuant to a related security agreement, by an interest in certain specified equipment. In one case, S absolutely assigns to B all of S's rights in a note and the related security agreement. In another case, S absolutely assigns to B, in separate clauses in the same agreement, all of S's rights in the payments due under a note as well as all of S's other rights in the note and the related security agreement. In each case, B neither files nor takes possession of the note or the related security agreement. Like the equipment leases in paragraph A above, each note, together with the related security agreement, constitutes tangible chattel paper. In the first case, B runs the risk of having its interest in the note and the related security agreement primed by a subsequent purchaser that meets the requirements of Section 9-330(b). In the second case, however, because the payment rights under the note are "stripped" (*i.e.*, separately assigned), the payment rights could, under the holding of the Case, be classified as payment intangibles. In that event, it appears that a subsequent purchaser who takes possession of the note and the related security agreement and otherwise meets the requirements of Section 9-330(b) would not be able to prime B's prior interest in the payment rights.

D. D sells to SP1 all of D's rights in the principal and interest payments and other fees, costs and charges (including any prepayment premium) under an unsecured non-negotiable promissory note and grants to SP1 a security interest in all of D's other rights in the note. SP1 neither files nor takes possession of the note. Later, D grants to SP2, as security for a loan, a security interest in all of D's rights in the note. As part of the loan transaction, SP2 takes possession of the note. Assume that SP2 otherwise meets the requirements for priority in instruments set forth in Section 9-330(d). Assume further that D becomes insolvent and there is a priority contest between SP1 and SP2 with respect to the payments under the note. SP2 argues that its interest in the note qualifies for priority under Section 9-330(d), that the payments under the note constitute proceeds of the note and that, as a result, SP2's interest in the payments primes SP1's interest in the payments. SP1 argues that the payment rights in the note are distinct from the note itself, the former being payment intangibles and the latter being an instrument (*i.e.*, a writing that evidences a right to the payment of a monetary obligation as opposed to the right to the payment of the monetary obligation itself). SP1 further argues that, having been "stripped," the payment rights in the note are not proceeds of the note (the note being merely the writing evidencing the payment rights as opposed to the payment rights themselves). If SP1's analysis is correct, Sections 9-330(d) and 9-322(c)(2) will not protect SP2. According to SP1, under Section 9-330(d) SP2 may be a qualified purchaser of the *writing* that evidences the payment rights, but SP2 is *not* a qualified purchaser of the payment rights evidenced by the writing. And even if SP2 is deemed to be a qualified purchaser of the note and all related rights (including payment rights) under Section 9-330(d), because D did not have rights or the power to transfer rights in the payment rights at the time of the loan transaction, SP2 does not have a *security interest* in the payment rights under the note (either as original collateral or as proceeds) and thereby fails to meet the stated requirements for priority set forth in Section 9-322(c)(2). Is it clear that SP1 is wrong? If requested, would a law firm that is experienced in UCC matters give an opinion to the effect that SP2's interest has priority over SP1's interest with respect to the payment rights?

E. S is the owner of a promissory note that is secured by an interest in certain specific goods. The security interest in the goods is created by a security agreement that is separate from the note. Pursuant to a written purchase and sale agreement, S absolutely assigns an undivided 10% interest in all of its rights in the note to B. In the purchase and sale agreement, S specifically reserves for itself the benefit of all security interests created by, and all enforcement and other rights arising under, the security agreement. Assume that B neither files nor takes possession of the note. By separately assigning an undivided 10% interest in the note without the benefit of any security, has S "stripped" a portion of the note from the chattel paper (the note and the security agreement taken together)? If so, is B's undivided 10% interest in the note automatically perfected under Section 9-309(4)?

We expect that there are other difficult questions raised or unexpected results produced by the collateral classification holding and related analysis in the Case.

6. Suggested Resolutions

Here are two (but by no means the only) possible resolutions that have been proposed by the UCC Committee to address the priority and other issues created by the holdings in the Case:

A. *To avoid "shifting collateral" problems, amend the UCC to provide explicitly that chattel paper and instruments include the related payment rights and make certain related changes.*

(1) Amend Section 9-102(a)(11) to provide that "chattel paper" includes the monetary obligations evidenced by the related record or records.

(2) Amend Section 9-102(a)(47) to provide that an "instrument" includes the right to the payment of a monetary obligation evidenced by the related negotiable instrument or other writing.

(3) Add a new provision stating that a separate assignment of the payment rights or other rights arising under chattel paper or an instrument (whether in the same security agreement and otherwise and however phrased) does not create a general intangible or other type of collateral but instead

constitutes an assignment of the chattel paper or instrument (as applicable). This provision might be added as a new subsection to Section 9-203.

(4) Make technical amendments either to Section 9-318(b) or to Section 9-322(c) so that it is clear that the interest of a subsequent purchaser of chattel paper or an instrument who takes possession and otherwise meets the requirements for priority set forth in Section 9-330(b) or (d) will also have priority in any payments arising under the chattel paper or instrument.

B. *Amend the UCC to provide that perfection in payment intangibles derived from chattel paper is not automatic and must be achieved by possession of the chattel paper or by filing.*

As the main concern with the holding in the Commercial Money Center case is the desire to protect a subsequent chattel paper purchaser against a "secret" prior true sale of the payment stream, proposal B is a simple one:

(1) Amend Section 9-309(3) to expressly exclude payment intangibles derived from (*i.e.*, stripped from) chattel paper.

This amendment would directly address the priority problem raised by the court's holding due to automatic perfection in a sold payment intangible derived from chattel paper. This amendment would also not hinder in any substantial way the stripping of payment streams from chattel paper because the buyer of the payment streams would be able to protect its interests by filing or taking possession of the chattel paper to perfect. The later purchaser of the chattel paper would be placed on notice by the filing or possession by the earlier buyer of the chattel paper.

(2) Amend Section 9-318(b) to add the following sentence: "For purposes of determining the rights of creditors of, and purchasers for value of chattel paper from, a debtor that has sold a payment intangible derived from such chattel paper, while the buyer's security interest is unperfected or perfected by filing, the debtor is deemed to have rights and title to the payment intangible identical to those the debtor sold."

This amendment would address the concerns raised by commentators that the later purchaser of the chattel paper -- even one that took possession -- would end up with an "empty shell" because the payment stream had been stripped out. A later purchaser of the chattel paper who takes possession should prevail not only against a prior buyer who is unperfected but also against a prior buyer who perfects by filing.

(3) Amend Section 9-330(b) by inserting "or in any payment intangible derived from the chattel paper" immediately after the second reference to "chattel paper" in that section.

This amendment (when coupled with the other two amendments) would clear up any ambiguity in Sections 9-330(b) and (c) and 9-322(c) that a subsequent purchaser of chattel paper who takes possession and otherwise meets the various conditions of Section 9-330(b) would have priority over the earlier buyer of the payment stream.

Should either proposal be adopted, we offer to recommend corresponding changes to the Official Comments that would need to be made.

* * *

In closing, we are submitting this letter in the interest of contributing to the lively discussion and debate regarding the ramifications of the Case. We have offered two proposals to resolve the real and significant impact that the Case will have on secured transactions. By limiting our proposed resolutions to the two set forth in this letter, we do not mean to imply that our resolutions are either exhaustive or complete. We may have other possible resolutions to propose at a future date, or, alternatively, we may opt to develop further those already proposed. In all cases, however, we wish to assist the PEB in its consideration of the Case and its resolution and wish to remain engaged in this process to the extent that the PEB deems helpful. To that end, if any portion of this letter seems unclear and requires further explanation, we will be happy to provide the same upon request.

Sincerely yours,

James S Coch

James S. Cochran
Co-Chair

Overview of Securitization, True Sale, and Payment Stripping

This Appendix 1 attempts to address the question of whether there is a business need or reason to "strip" and sell a payment and therefore create, or to re-characterize the lease receivable payments as, a sold "payment intangible" which is afforded automatic perfection under Section 9-309(3) when sold.[1]

1. Securitization

The court in the Case states that "[w]e are told that the multi-billion dollar securitization industry depends on being able to fractionalize financial assets, and specifically on stripping payment streams from underlying transactions such as the equipment leases in this case." (Case at 2.) This statement is an acknowledgement of the relative obscurity surrounding the securitization industry and process. The goal of securitization is, however, in its essence, relatively straightforward: it is the creation of publicly or privately offered (and traded) securities, typically in the form of commercial paper, notes or certificates, backed by the securitized receivables pool. As discussed below, whether a securitization is structured as loan or sale of a lease portfolio to a bankruptcy-remote "special purpose entity" ("SPE") or to a lender's commercial paper conduit, securitization is both relatively common and vital to the leasing industry, as the securitization industry provides a source of relatively low-cost liquidity[2] to a lessor's portfolio of lease assets, with the ability to raise additional investment capital from its lease portfolio and to redeploy that capital in new higher-yielding transactions, increasing the lessor's profit potential.

A. Special Purpose Entity

A securitization is essentially a two-step process. The issuance of the securities backed by the receivables is the second step. The first step of the process, in a "classic" lease pool securitization, is for a leasing company to "package" and transfer a portfolio of its lease transactions via a "true sale" of the receivables, the underlying leases and the leased equipment (collectively described as the "lease pool") to an SPE formed

[1] This question was raised by Donald J. Rapson on the UCC ListServ in his September 1, 2006 posting: "what exactly are the purported benefits of stripping the payment stream from the underlying chattel paper or promissory note?"

[2] Although the interest or certificate rate of the securities backed by the securitized lease pool is usually significantly lower than the lessor's borrowing rate, largely due to risk diversification and credit support, the lessor's true cost of the securitized sale or borrowing must include the significant transactional costs of the attorneys, accountants, and other professional or financial advisors engaged by the transaction parties as well as the costs of the surety bond and portfolio credit rating. These costs are typically borne by the lessor, and therefore, the "all-in" cost to the lessor is considerably higher than the interest or certificate rate of the asset-backed securities. Nonetheless, in many instances the all-in cost to the lessor is still less than the lessor's own borrowing rate, or lease portfolio sale value, without the securitization. Even if the all-in cost of the securitization is relatively high, the lessor may nevertheless be forced to securitize in order to raise additional investment capital due to a limited borrowing capacity arising from pre-existing high leverage ratios on its balance sheet.

specifically to take title to the lease pool, which SPE then issues securities backed by the lease pool.

B. Sale vs. Loan Securitization Structures

The possibility has been raised on the UCC ListServ that the Commercial Money Center transactions were not "true securitizations" as there was no SPE in the structure.[3] We believe the lack of an SPE is not relevant to the analysis. A securitization can be accomplished within a number of different structures. The complexities of the securitization process arise from the nuances of the transaction, which attempt to address legal, accounting, and credit issues. Securitization structures range from relatively complex "classic securitizations" (*i.e.*, "true sales" to an SPE formed to achieve bankruptcy remoteness) to rather straightforward loans made by a lender and secured by a prior perfected security interest in the borrower's lease portfolio, which loans are then transferred by the lender to its affiliated "commercial paper conduit" (*i.e.*, the lender's own SPE). In an alternative structure to a "true sale," the lessor/packager assigns the lease payments and grants a security interest in the remainder of the lease pool (*i.e.*, the other rights under the leases and the residual rights in the equipment) to a lender's captive commercial paper conduit, which commercial paper conduit acts to consolidate similar lease pools packaged and transferred from other leasing companies, with the goal of achieving economies of scale and risk reduction via portfolio diversification and ultimately issuing commercial paper backed by the lease receivables.[4]

C. Surety

In either the "true sale" or "loan" securitization scenario, depending on the credit quality of the portfolio, there may be a requirement or necessity for surety bonding to support the credit quality of the portfolio. As such, securitization structures typically provide for some form of surety, recourse, indemnity or other credit support to bolster the credit profile of the securitized pool and thus enhance the rating given by the rating agency (such as Moody's, S&P or Fitch) to the securities backed by the pool.[5] The goal of the "sponsor parties" (*e.g.*, the lessor or the lender) desire to achieve a sufficiently-enhanced credit rating on the portfolio to assure that the asset-backed securities to be issued by the SPE or commercial paper conduit are marketable.[6]

---

[3] See Donald J. Rapson's posting on the UCC ListServ of October 12, 2006: "it has now been determined that this case did not involve a securitization. There was no Special Purpose Vehicle (SPV) in the structure of the transaction. Consequently, characterizations of this case as a 'classic securitization' are incorrect." This posting was responded to later the same day on the UCC ListServ by Tom McCurnin, who identified himself as one of the attorneys who worked on the Case and who indicated that, in approximately 25% of Commercial Money Center's lease pools, an SPE was used to securitize the pools.

[4] A further discussion of the reasons for utilizing the sale over the loan structure is provided below in this Appendix 1.

[5] Please see diagrams of the Commercial Money Center structure as well as of a "classic" securitization and alternative structures in Appendices 2 through 5 to this letter.

[6] Thus, for many pools of lease assets (particularly pools that are of "sub-prime" credit quality, as in the Case), a surety is essential to the issuance of securities backed by the pools as the surety assures, to the satisfaction of the rating agencies rating the transaction and for the benefit of the future holders of the

2. True Sale

The first-step of the securitization mentioned above, the packaging and transfer of the lease portfolio to the SPE or commercial paper conduit, typically requires some closer analysis as the securitization structure can exist anywhere in a continuum that runs from transactions that are clearly structured and intended as debt to transactions that are clearly structured and intended as sales.

As for Commercial Money Center's securitization structure, it appears from the facts provided in this case that the debtor/seller of the lease portfolio, Commercial Money Center, and the secured party/purchaser, NetBank, desired to achieve a "true sale" securitization structure. Notwithstanding the parties' stated intentions, it also evident from the economic substance of the transaction (*e.g.*, the reversionary interest of Commercial Money Center in the payment stream, the guaranteed minimum payments, the indemnity contract and the substantial continuing servicing obligations) -- and, as noted in section 2 of the letter, the court held -- that the transaction had more of the risk allocation and economic substance of a loan than of a sale.

In answer to a question posed on the UCC ListServ, there is a credible *business* explanation as to why Commercial Money Center might have desired to "strip the payment stream from the leases."[7] A "true sale" of the lease portfolio would have allowed Commercial Money Center to accomplish two business goals which could not be achieved via a "loan" securtization structure. Those two goals, which are briefly discussed below, are (i) off-balance sheet "sale" treatment and (ii) immediate recognition of income.

Off-Balance Sheet "Sale" Treatment: The seller receives off-balance sheet treatment, meaning that the leases and the related equipment are no longer assets on the lessor/seller's balance sheet and that the corresponding "securitized loan" (which has been re-characterized as a sale) is no longer a liability on its balance sheet. This considerably "cleans-up" the balance sheet of the lessor/seller and can be a significant benefit, particularly for a smaller leasing company with limited equity capital resources, and which must turn to debt capital to acquire its lease portfolios. A lessor/seller with a very high debt-to-equity ratio has fewer financing options because lenders are increasingly reluctant to lend to such a lessor. In that case, the sale of the lease assets increases the equity capital and net worth of the lessor, making the lessor's balance sheet view more attractive to lenders.

---

securities, that there is a relatively guaranteed fixed stream of payment receivables, eliminating much of the risk of underlying lessee credit defaults. If this risk were not greatly reduced, the issuance of securities backed by the pools would be hindered as the securities would be difficult to evaluate by the financial markets. On the other hand, a relatively guaranteed fixed stream of payments is easily valued by the financial markets as an annuity, by discounting to present value the expected payment stream using an appropriate credit-risk-adjusted discount rate (which the applicable rating agencies' ratings effectively will pre-determine as such discount rate will largely be based upon their ratings).

[7] See Donald J. Rapson's September 29, 2006 posting on the UCC ListServ and footnote 1 above in this Appendix 1.

Immediate Recognition of Income: The seller achieves immediate "gain on sale" income recognition of the securitized portfolio payment stream sale proceeds, in contrast to a loan where the principal amount of the loan would be retained as a liability on the lessor's balance sheet, and the income (the difference between the principal and interest payments and the rental income) would be amortized over the life of the loan. Without "true sale" treatment, the borrower would have to recognize the income from the transfer of the portfolio to the lender over the life of the portfolio, which might range from 24 to 36 months for a high-tech lease portfolio, from 48 to 60 months for most generalized equipment, and from 72 months to 84 months (or higher) for longer-life lease assets.

3. Payment Stripping

Less common, but still within the scope of securitization structures in the leasing world (and as attempted by Commercial Money Center), is for a lessor to structure a sale transaction in which only the lease payments, and not the underlying leases or equipment, are sold (*i.e.*, a "stripping"). A true sale of a payment stream only, if properly structured, would allow the seller to accomplish two important business goals in addition to immediate income recognition and off-balance sheet financing: (i) retention of residual value interest in the underlying leases and equipment; and (ii) the ability to depreciate the leased equipment for tax purposes (*i.e.*, to utilize the depreciation deductions and other capital allowance benefits under the Internal Revenue Code).

Retention of Residual Value Interest: "Stripping" the lease payments allows the lessor to obtain the benefits noted above under sale treatment, yet retain ownership of the leases and the underlying equipment, an important profit component for the lessor. In true "fair market value" leases, the value of this residual interest could be considerable and could represent substantially all, if not all, of the profit in the transaction for the seller.[8] In a "lease intended as security," the residual interest retention would not represent as much of a profit potential, but it could still be significant, even with 10% "puts" or bargain purchase options (as appears from the UCC ListServ was the structure of the Commercial Money Center lease pools).[11]

Ability to Retain Tax and Accounting Benefits: The retention by a lessor of the ability to depreciate the equipment for tax purposes is of considerable value to a true "fair market value" lessor (a lessor under a lease with a "fair market value" purchase option, which would likely entitle the lessor to claim tax benefits under the Internal Revenue Code). As the Commercial Money Center leases appear to have been disguised financings with 10% purchase options, Commercial Money Center would not likely have been able to take the tax benefits available to owners of capital equipment. However, the

[8] It is noted that the retention of the residual value in the equipment is one of the more favorable aspects to the lessor of the "loan" (as opposed to the "true sale") securitization structure. In a "loan" structure, the rights to the equipment remain with the lessor (albeit subject to the lender's security interest). By contrast, in a "true sale" structure the lessor relinquishes its interest in the equipment – unless, of course, the lessor structures the transaction as a sale of the "stripped" portfolio lease payments only, in which case the lessor will retain its ownership interest in the equipment and the associated tax and accounting benefits.

[11] See Thomas McCurnin's posting of October 18, 2006.

ability to take tax allowances or credits, such as under the Modified Accelerated Capital Recovery System, or investment tax credits, and any other available capital equipment investment tax benefits, would be a clear benefit to other leasing companies, particularly where profits margins are thin. An additional benefit to a lessor/seller who retains legal title to the underlying leased equipment assets is to allow the lessor/seller to depreciate the equipment for book purposes. This benefits the lessor's balance sheet by allowing the lessor to continue to reflect an asset (the equipment's residual value) on the lessor's balance sheet, strengthening the balance sheet and making (among other benefits) lenders more likely to extend credit to the lessor.

Consequently, the four goals described above in parts 2 and 3 of this Appendix 1 (*i.e.*, off-balance sheet treatment, immediate recognition of income, retention of residual value interest, and the ability to receive certain tax and accounting benefits) are achievable simultaneously only by structuring a transaction as a "true sale" of the payment stream ***alone*** (*i.e.*, by "stripping") without a corresponding sale of the underlying chattel paper or leased equipment.[12] It bears repeating, however, that the

---

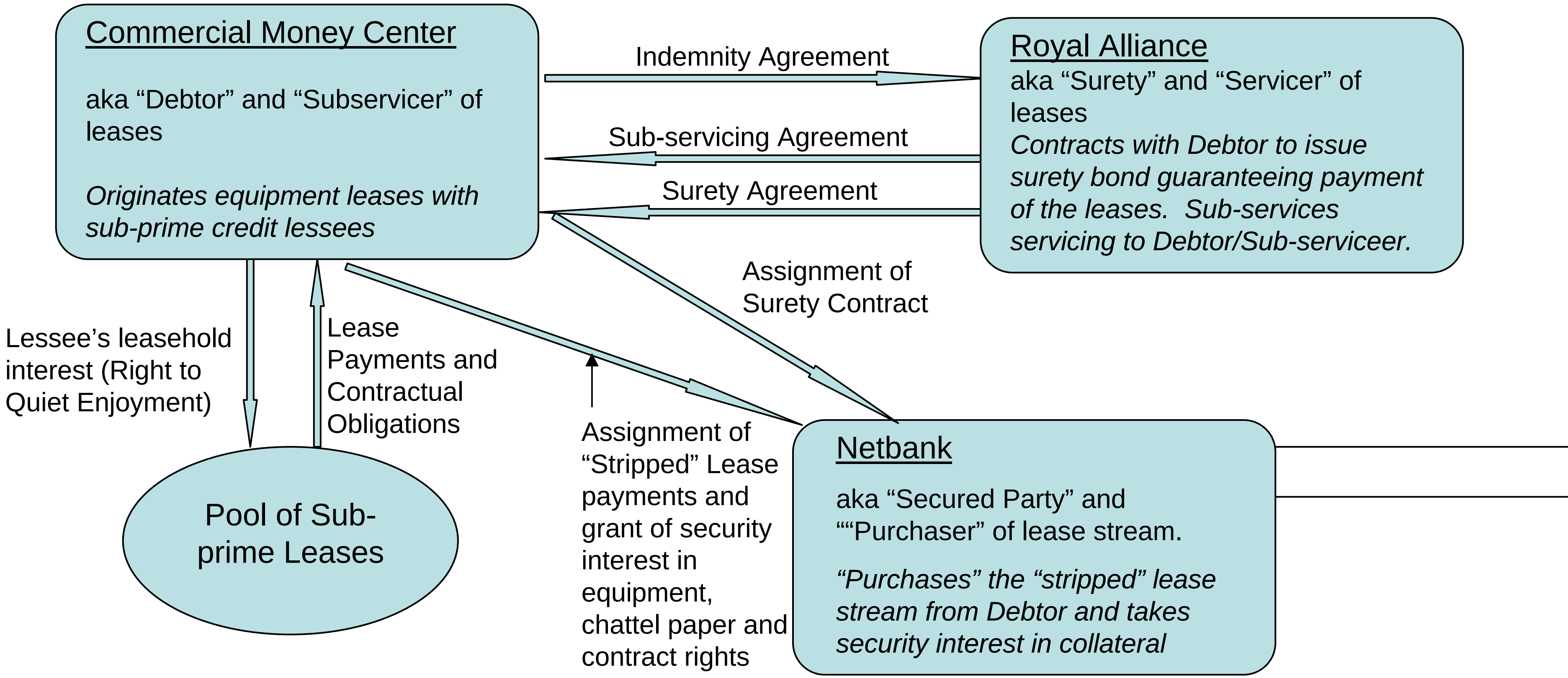
[12] In the Case, the court's legal conclusion that payment intangibles had been created rested on its factual finding that the lease payments had been "stripped" from the leases themselves. According to the court, pursuant to each Sale and Servicing Agreement between Commercial Money Center and NetBank ("SSA"), Commercial Money Center assigned "its contractual rights to future lease payments" and "its rights under the surety bonds" to NetBank. (Case at 2-3.) In addition, "as security for NetBank's receipt of the lease payments and any surety bond payments, [Commercial Money Center] granted NetBank a security interest in the underlying leases and other property." (Case at 3.) In other words, stated the court, Commercial Money Center "assigned NetBank both an interest in the payment streams and an interest in the underlying leases, but it separated the two interests." (Case at 3.) From the simple fact of "separation" (accomplished merely by the particular wording used in the SSA), the court went on to conclude that the lease payments were neither chattel paper nor accounts and, for that reason, necessarily fell "within the payment intangible subset of the catch-all definition of general intangibles." (Case at 15-16.) Although the court acknowledged that a payment intangible is, as defined under Section 9-102, a general intangible under which the account debtor's principal obligation is a monetary obligation, the court did not undertake any analysis whatsoever of the lessee's obligations under the leases (whether under the payment provisions of the leases or otherwise). (See Case at 16.) If the court had done so, the court might have concluded that the lessees had numerous material obligations under the leases in addition to the payment obligations and that these additional obligations could not be separated from the payment obligations or treated as secondary obligations in comparison to the payment obligations by the mere use of some words rather than others in the SSA. For example, the leases that were the subject of the Case were likely "triple-net, hell-or-high-water" leases (*i.e.*, "finance leases" under Article 2A) under which the lessor contractually delegated to the lessee essentially all of the risks, obligations and responsibilities which typically reside with an owner of equipment. These risks, obligations and responsibilities, which derive from the equipment or from its possession and use, include, among others, those related to (1) loss and liability, (2) maintenance, performance and condition, and (3) fees, charges, taxes and assessments. In short, the court might have concluded that, despite the attempted "separation" of the payment rights from the other rights under the leases, the lessees' obligations to make payments under the leases were inescapably and unavoidably intermingled with the lessees' other material obligations under the leases, which would make it impossible to isolate the lessees' payment obligations from their other obligations and then characterize the payment obligations as the "principal" obligation in a set of obligations that, merely as a result of the words used in the SSA, was designed to exclude all non-payment obligations (Case at 3 and 4). If the court had engaged in a fuller analysis such as that described above in this footnote, it is very possible that the court would have avoided the simple (and, some would argue, simplistic) legal conclusion that the mere use of particular granting words in the SSA were sufficient to transmute the payment rights under the lease chattel paper into payment intangibles as defined in Section 9-102.

"stripping" of payments is not necessary to achieve the goal of securitization, which is simply the ability to "securitize" the portfolio assets in order to achieve liquidity at a lower borrowing rate.

In conclusion, although there is a *"business need"* to sell stripped lease payments in order to obtain favorable accounting and tax treatment, and retain profit potential, there is no need to treat these various structures differently from the sale of, or loan secured by, the underlying chattel paper under Article 9. The filing of a UCC-1 financing statement, or possession of the chattel paper, is, in our experience, an almost universal practice in these transactions, and we believe that the securitization industry would not be greatly inconvenienced by making this a requirement for perfection in "stripped payment" securitization transactions, as suggested in the body of this letter. In fact, the securitization industry would likely be greatly relieved by the certainty of a required UCC-1 financing statement filing, or possession of the underlying collateral, to assure perfection and relative priority in stripped payments and other interests transferred under chattel paper.

Commercial Money Center Case
Case Parties Diagram

Appendix 2



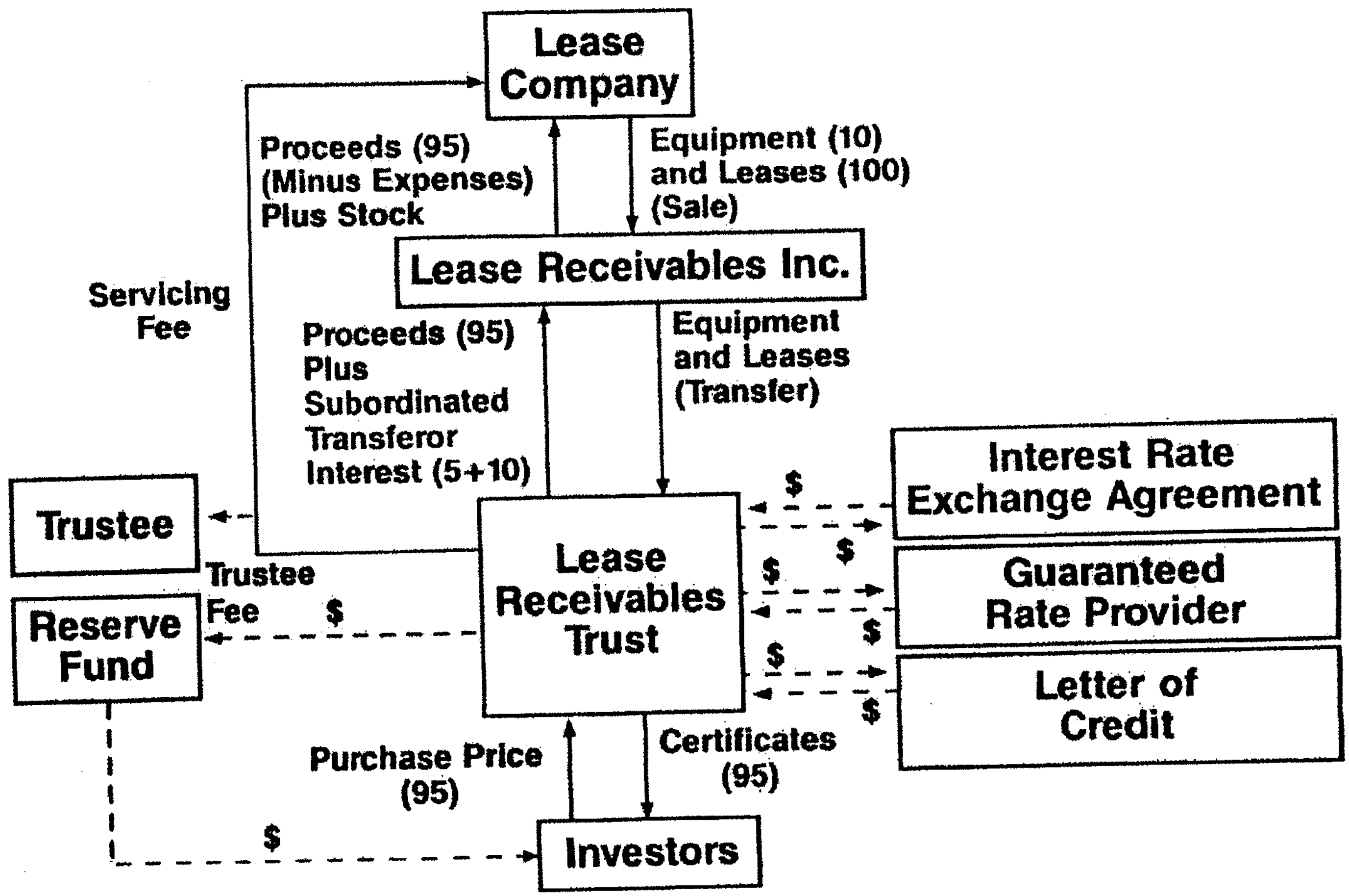
Issue #1: Is the payment stream chattel paper (section 9102 (a) (11)) or a general intangible (section 9102 (a) (42) and (61))
Held: general intangible, namely a payment intangible

Issue #2: Is the assignment a sale or a security interest? If a sale (and a payment intangible), then the transaction is automatically perfected (section 9309 (3)); if a security interest, need to file or possess (there was no filing)
Held: a security interest

Issue #3: Did Debtor retain possession leases? If so, the security interest is unperfected and falls to the strong-arm challenge of the bankruptcy trustee
Held: Remand for factual determination

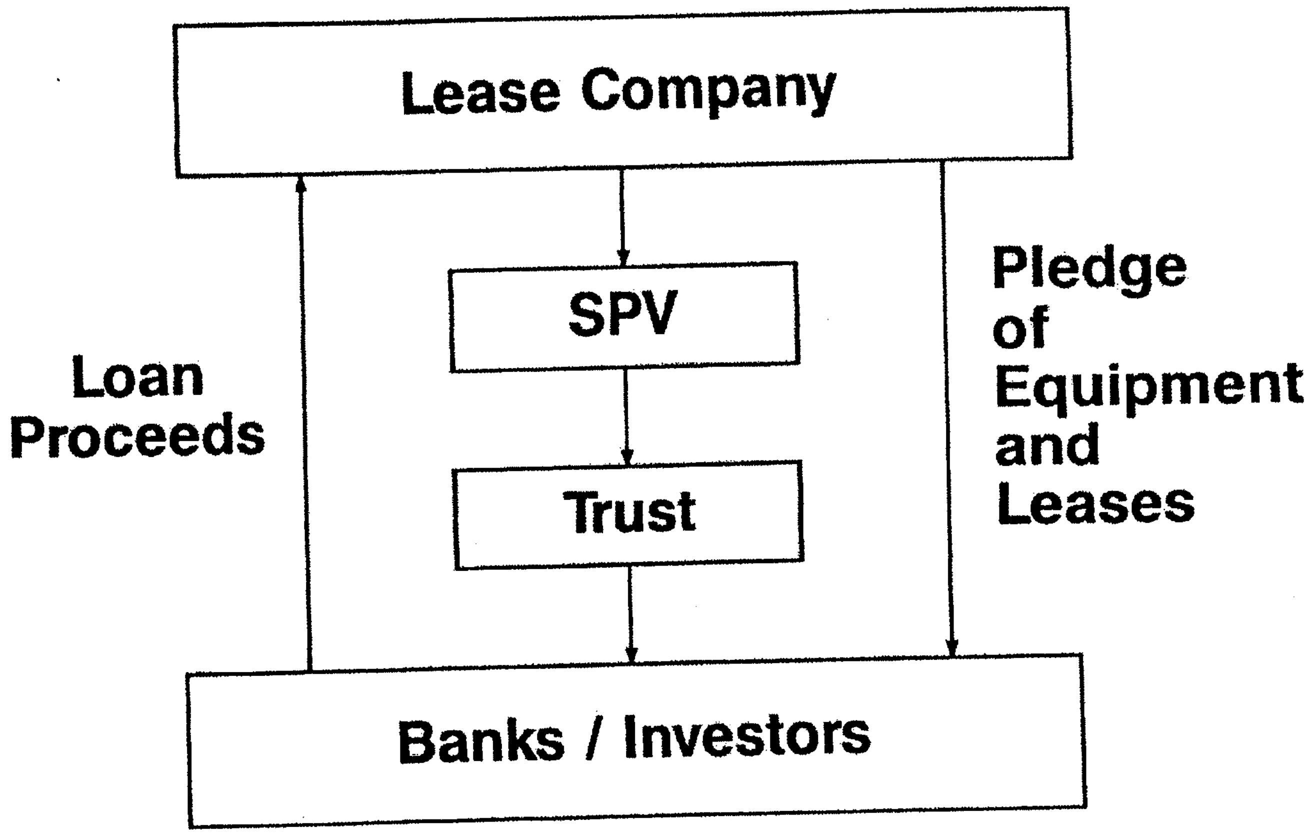
E49007.IMG 02/07/92:es

LEASE SECURITIZATION FINANCING



E49006.IMG 02/06/92:es

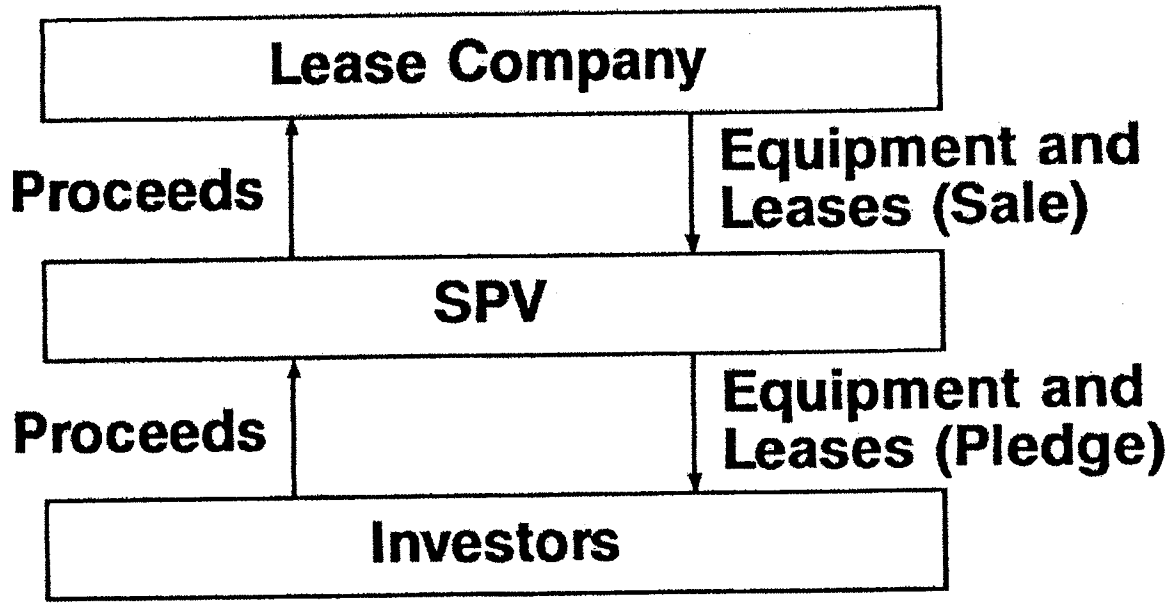
TRADITIONAL SECURED FINANCING



Appendix 5

E40016.IMG 02/06/02:06

ISOLATE ASSETS



- True Sale
- Nonconsolidation
- Bankruptcy Remote